

Office of Chief Counsel
Internal Revenue Service

memorandum

CC:WR:RMD:DEN:TL-N-3858-00

WRDavis

date: **AUG 23 2000**

to: Territory 1290 - Denver, Field Ops., Comm Technology & Med., LMSB
Attn: Revenue Agent Tom Roginski, Team 1294 MS 4402SO

from: District Counsel, Rocky Mountain District, Denver

subject: [REDACTED]:

Should a Notice of Deficiency or an FPAA reflect the adjustment for Assignment of Income to [REDACTED]?

This responds to your request for our views as to whether the adjustment for the assignment of income attributable to the capital gain in shares of [REDACTED] stock that you attribute to [REDACTED] should reside within a notice of deficiency issued to him, or within an FPAA issued to the [REDACTED].

DISCLOSURE STATEMENT

This advice constitutes return information subject to I.R.C. § 6103. This advice contains confidential information subject to attorney-client and deliberative process privileges and if prepared in contemplation of litigation, subject to the attorney work product privilege. Accordingly, the Examination or Appeals recipient of this document may provide it only to those persons whose official tax administration duties with respect to this case require such disclosure. In no event may this document be provided to Examination, Appeals, or other persons beyond those specifically indicated in this statement. This advice may not be disclosed to taxpayers or their representatives.

This advice is not binding on Examination or Appeals and is not a final case determination. Such advice is advisory and does not resolve Service position on an issue or provide the basis for closing a case. The determination of the Service in the case is to be made through the exercise of the independent judgment of the office with jurisdiction over the case.

Issues

Should the Service reflect its adjustment determining that [REDACTED] assigned income from the capital gain attributable to the sale of [REDACTED] common stock that he transferred to the [REDACTED], on or about [REDACTED], as an adjustment to [REDACTED]'s capital gains for his [REDACTED] tax year in a notice of deficiency, pursuant to I.R.C. § 6212, or should the recognition of the capital gain be reflected as an adjustment to a partnership item of [REDACTED] in a Notice of Final Partnership Administrative Adjustment (FPAA), pursuant to I.R.C. § 6223(a)(2)?

Facts

[REDACTED] is, and has been, at all times relevant, a director and major shareholder of [REDACTED] ([REDACTED]), a publicly-traded corporation. As of [REDACTED], [REDACTED] owned [REDACTED] shares of [REDACTED] common stock.

[REDACTED] undertook a secondary public offering of its stock, which closed on [REDACTED].¹ The initial discussions concerning that offering began not later than [REDACTED]. On that date, [REDACTED]'s Board of Directors established a Pricing Committee to negotiate the terms of an Underwriting Agreement, to determine the number of shares to be sold in the offering, and to determine the pricing of those shares. [REDACTED] and one other director were named as the members of the Pricing Committee.

Between [REDACTED], the secondary stock offering was the subject of meetings including the selling stockholders, [REDACTED], and the proposed underwriters. [REDACTED] was one of the selling stockholders.

On [REDACTED], [REDACTED] filed the preliminary prospectus for the secondary offering with the Securities and Exchange Commission (SEC). [REDACTED] requested that the SEC set the effective date of the registration statement as [REDACTED]. The registration statement called for the sale of [REDACTED] shares by certain stockholders, and included the underwriters' option to purchase [REDACTED] percent of this amount ([REDACTED] shares) as the over-allotment amount. Of the stockholders selling shares in the secondary offering, [REDACTED] was identified as selling [REDACTED] shares. Additionally,

¹ [REDACTED] had completed its initial public offering on [REDACTED], of [REDACTED] shares, at an offering price of \$ [REDACTED] per share.

_____ shares owned by the _____ were another source of shares to be sold. No shares owned by _____ were so identified, inasmuch as it did not yet exist.

. Additionally, on _____ the SEC was sent a preliminary Underwriting Agreement that stated that the underwriters intended to make a public offering of the shares purchased as soon as possible after the registration statement was approved by the SEC. Conditions of the purchase commitment set forth in the preliminary Underwriting Agreement required no change as having occurred in _____'s financial condition that would have made it impracticable to market the shares as planned, nor could there have been any downgrade in the Company's securities.

On _____, _____, a Colorado Limited Liability Company, was incorporated. _____ was named as the manager and a _____% limited liability company member. His spouse, _____, was named as the _____% member. Additionally, that same day, _____, a Colorado Limited Liability Limited Partnership (_____, filed its "Certificate of Limited Partnership" and its "Registration Statement as a Registered Limited Liability Limited Partnership" with the Colorado Secretary of State. _____ was named as _____'s general partner, with a _____% interest, and _____ as a limited partner, with a _____% interest in _____. _____ was executed _____, by _____, both as Manager of the _____ and as the "Limited Partner."

On _____, _____ sent to _____ counsel handling the secondary offering, by overnight courier, many documents needed to complete the transaction. It appears that several of them were signed in blank, inasmuch as the final details concerning such aspects as the number of shares to be sold had not yet been decided. Among the documents transferred were _____'s stock certificate _____, which he had endorsed.

In exchange for a _____% interest as a limited partner of _____, _____ transferred to it _____ shares of _____ stock. A Partnership Agreement exhibit reflects the transfer as having occurred on _____, but schedules included with this request show otherwise. Rather, two "Assignment Separate from Certificate" documents executed by _____ reflect that _____ shares were transferred to _____ on _____, and that the remaining _____ shares were transferred on _____. The latter shares transferred made up part of the additional _____ shares approved for sale by the SEC on _____.

In form, through the series of transactions, [REDACTED] was a partner of [REDACTED] only momentarily. An amendment to the [REDACTED] Partnership Agreement dated [REDACTED], reflects that [REDACTED], as Trustee of the [REDACTED], dated [REDACTED], became the successor partner holding the [REDACTED] % interest transferred to it by [REDACTED] under an Assignment, with a stated effective date of [REDACTED].²

On [REDACTED], [REDACTED] asked the SEC to accelerate the effective date of the Registration Statement to [REDACTED]. Pursuant to securities law, the Registration Statement effective date must precede the offering. On [REDACTED], the SEC notified [REDACTED] that the effective date was [REDACTED].

Additionally, on [REDACTED], the final Underwriting Agreement was signed. This set the offering price at \$ [REDACTED] per share, less a [REDACTED] % commission retained by the underwriters. Disbursement of the funds was required by [REDACTED]. Additionally, it contained a "lock-up" agreement, whereby the stockholders contributing the shares to the offering agreed not to sell or transfer any additional shares until after [REDACTED]. The Underwriting Agreement execution followed the [REDACTED] Pricing Committee of the Board of Director's approval of the terms of sale. It appears that the offering price was based upon the NASDAQ market price for the stock during the preceding month, and the feedback gained from the presentations made by [REDACTED] officers along with representatives of [REDACTED], the managing underwriter, during the preceding month. The average closing price of [REDACTED] stock during the month of [REDACTED], was \$ [REDACTED] per share.

On [REDACTED], [REDACTED] notified the SEC that the number of shares offered by the selling stockholders had increased by [REDACTED], to [REDACTED], and the underwriting overallotment had increased by [REDACTED], to [REDACTED]. That same day, [REDACTED]'s stock certificate was received by [REDACTED]'s stock transfer agent. Since it was known that all the stock transferred to [REDACTED] was being sold in the secondary offering, the transfer agent did not

² Additionally, [REDACTED] transferred [REDACTED] shares of [REDACTED] stock directly to the [REDACTED], transferring [REDACTED] on [REDACTED], and [REDACTED] on [REDACTED]. These transfers increased [REDACTED]'s holdings from [REDACTED] shares to [REDACTED] shares, all of which were sold in the secondary public offering. The treatment of the capital gain on these shares is not a subject of this memorandum.

issue a stock certificate to [REDACTED]. Thereafter, it issued [REDACTED] a new certificate, reflecting his reduced holdings in [REDACTED].

The final Underwriting Agreement identified the shares held by [REDACTED] as being among those shares to be sold to the general public through the secondary public offering, with the transfer to the underwriting group occurring on [REDACTED]. On its return, [REDACTED] reported a long-term capital gain on the sale of [REDACTED] shares, and identified the entire amount of the capital gain from that sale as allocable to [REDACTED] on the trust's Schedule K-1 for the partnership taxable year ended December 31, [REDACTED], purportedly in conformance with I.R.C. § 704(c).

You propose to shift this gain reported by [REDACTED] to [REDACTED] through an FPAA, based upon your view that [REDACTED]'s basis in the transferred stock is a "partnership item." You base this on your view that the gain had "ripened" in [REDACTED]'s hands prior to the [REDACTED] stock transfer by [REDACTED] to [REDACTED], and constituted an assignment of income. You point out that [REDACTED] was, momentarily, a partner of [REDACTED] before his assignment of his partnership interest to [REDACTED].

Analysis

[REDACTED] is a partnership within the meaning of sections 761 and 7701(a)(2) and is subject to the unified audit and litigation procedures for partnership items under sections 6221 through 6233.³ To determine whether the adjustment proposed is a partnership item, subject to such procedures, requires reference to the definition contained at section 6231(a)(3). That section defines a "partnership item" as follows:

The term "partnership item" means, with respect to a partnership, any item required to be taken into account for the partnership's taxable year under any provision of subtitle A to the extent regulations prescribed by the Secretary provide that, for purposes of this subtitle, such item is more appropriately determined at the partnership level than at the partner level.

Section 6231(a)(3).

³ We note that, pursuant to section 6231(a)(1)(B)(i), as then in effect, the inclusion of [REDACTED] prohibited [REDACTED] from qualifying for the small partnership exception to the unified partnership audit provisions.

Treas. Reg. § 301.6231(a)(3)-1(a) generally sets forth, in pertinent part, that (a) the partnership aggregate and (b) each partner's share of "[i]tems of income, gain, loss, deduction, or credit of the partnership," items which are required to be taken into account for the partnership taxable year, are more appropriately determined at the partnership level than at the partner level and, therefore, are partnership items. Treas. Reg. § 301.6231(a)(3)-1(a)(1)(i). Further, to the extent that a determination of such items can be made from determinations that the partnership is required to make with respect to an amount, the character of an amount, or the percentage interest of a partner in the partnership, for purposes of the partnership books and records or for purposes of furnishing information to a partner, items relating to the following are partnership items:

1. Contributions to the partnership;
2. Distributions from the partnership; and
3. Transactions to which section 707(a) applies (including the application of section 707(b)).

Treas. Reg. § 301.6231(a)(3)-1(a)(4).

In illustration of paragraph -1(a)(4), the regulations expound on the situations where such determinations are to be considered as partnership items, identifying the critical element as the partnership's need to make such determinations, regardless of whether it actually does. Among them, Treas. Reg. § 301.6231(a)(3)-1(c)(2) points out that a partnership needs to determine, for its books and records, or for purposes of furnishing information to a partner, the basis to the partnership of contributed property (including necessary preliminary determinations, such as the partner's basis in the contributed property). Treas. Reg. § 301.6231(a)(3)-1(c)(2)(iv). To the extent that a determination of an item relating to a contribution can be made from these and similar determinations that the partnership is required to make, that item is a partnership item. To the extent that the determination requires other information, however, that item is not a partnership item. Treas. Reg. § 301.6231(a)(3)-1(c)(2) (flush language).

With exceptions not relevant here, the Code establishes a partnership's basis of property contributed to it by a partner as the contributing partner's adjusted basis of such property at the time of the contribution. Section 723. This clearly leads credence to the use of the partnership audit as the proper method of reflecting such an adjustment.

However, our review of the case law shows that a determination of income to [REDACTED] under the "assignment of income" doctrine could potentially show up in either a partnership determination or in an adjustment to his income tax liability. In Gemini Twin Fund III v. Commissioner, T.C. Memo. 1991-315, the Tax Court addressed the question of the amount of the partner's year-end capital accounts, which determined the portion of partnership losses that the partners could deduct, in the context of a partnership proceeding brought pursuant to an FPAA. There, the partnership had included in its computation of the partner's capital accounts a promissory note given by them to the partnership under the partnership agreement.

Citing Dial USA, Inc. v. Commissioner, 95 T.C. 1 (1990), for the proposition that the partnership proceeding does not give the Court jurisdiction to determine the amount of a partner's basis, the court nonetheless determined that the partners had no adjusted basis in their own notes, and upheld the Service's adjustments to the partners' capital accounts.

Dakotah Hills Offices Ltd. Partnership v. Commissioner, T.C. Memo. 1996-35, lends further support for use of the FPAA. In that case, the limited partners had contributed promissory notes to the partnership as payment of 80 percent of their capital contributions to it. These notes were then pledged as collateral to a third-party creditor, securing the partnership's note to the creditor. In addition, the partnership purchased a financial guaranty bond from a surety, warranting payment to the creditor if the limited partners defaulted on their capital contribution notes, pledged by the partnership to the creditor.

At some point, some or all of the limited partners ceased paying on their notes. Thereafter, the surety paid the outstanding balance on the defaulted capital contribution notes to the creditor, and sued those partners who had defaulted. Thereafter, several partners and the surety entered into an agreement by which the partners were relieved of liability on their capital contribution notes in exchange for either the abandonment, or the conveyance, of the partnership interest to the surety. The Service issued the partnership an FPAA determining that the discharge of liability on the partners' capital contribution notes resulted in a partnership distribution, pursuant to section 752(b).⁴

⁴ Section 752(b) states that "[a]ny decrease in a partner's share of the liabilities of a partnership, or any decrease in a partner's individual liabilities by reason of the assumption by the partnership of such individual liabilities, shall be

The partnership sought summary judgment dismissing the case on the ground that the adjustments did not involve partnership items, arguing that the settlement agreement between the surety and the limited partners took place entirely outside of the partnership, such that the determination of any item relating to that transaction could not be a partnership item within the meaning of section 6231(a)(3) and the regulations thereunder. Specifically, the partnership focused on Treas. Reg. §§ 301.6231(a)(3)-1(a)(4) and -1(c)(3), arguing that an item relating to a distribution from the partnership is defined as a nonpartnership item to the extent that a determination of that item requires "other information." Since the settlement of the liabilities on the capital contribution notes took place between the partners and the surety individually, the partnership reasoned that this fact constituted information that was not in the possession or control of the partnership, and thus, was not a partnership item.

Rejecting this view, the Court focused not on whether Dakota Hills used information actually available at the partnership level to make a determination, but whether it was required to make a determination of that item. Pointing out that Treas. Reg. § 301.6231(a)(3)-1(a)(1)(v) requires a partnership to determine the partnership aggregate, and each partner's share of "Partnership liabilities (including determinations with respect to . . . changes from the preceding taxable year)," the Court concluded that the determination of a constructive distribution of money under section 752(b) that was brought about by a decrease in a partner's share of the partnership liabilities is a partnership item. Dakota Hills, T.C. Memo. 1996-35. In the instant case, [REDACTED]'s need to determine its basis in the stock contributed by [REDACTED] from facts outside the partnership parallels Dakota Hills' need to determine a constructive dividend from debt forgiveness.

In contrast to this stands the case of Investment Research Assocs. v. Commissioner, T.C. Memo. 1999-407. There, the Court considered, among other things, whether the Service could determine that income reported on the partnership return of a partnership subject to the unified partnership audit provisions was actually earned by the partner, an individual, through an adjustment to the individual's income contained on a notice of deficiency.

In that case, the partnership, Century Industries, purported

considered as a distribution of money to the partner by the partnership."

to have contracted with a third-party to provide services of two accountants, individuals who were also partners of the partnership, and reported the income from the third-party as commitment fees. The Service, using the "assignment of income" doctrine, determined a deficiency in one individual partner's income taxes by increasing the individual's income to reflect that he, rather than the partnership, had actually earned the "commitment fee" income.⁵

The Court rejected the taxpayer's position, stating, "If the commitment fees were [the partner's] income that he assigned to the partnership, then the asserted deficiency against him from the adjustment would not be attributable to a partnership item." Investment Research Assocs. v. Commissioner, T.C. Memo. 1999-407.

The summary report that you provided in connection with this request for advice makes clear that the primary position that you make employs use of the "assignment of income" doctrine to determine that the gain on the stock sale was realized before the stock was sold to the underwriters on [REDACTED]. The facts that you set forth support your position that the secondary public offering had progressed sufficiently far that the gain from the shares transferred to [REDACTED] had "ripened" in [REDACTED]'s hands prior to their transfer. Based on this theory, we believe that the appropriate method of making this adjustment is through an adjustment recognizing the long-term capital gain of the [REDACTED] shares transferred by [REDACTED] to [REDACTED] in a notice of deficiency to [REDACTED] for his [REDACTED] income tax year.

However, based upon the authority of cases such as Gemini Twin Funds III and Dakotah Hills, and the unsettled question of whether the regulations that delay the effective date of donative transfers of stock until the transfer is registered on corporate stock records will apply where a partnership interest, rather than stock, is what was actually transferred to [REDACTED], we recommend that you also reflect the determination of income on the sale of the [REDACTED] stock as [REDACTED]'s distributive share of long-term capital gain, as your request for advice suggests.

⁵ The taxpayer disputed the Service's adjustment by seeking to dismiss the adjustment for lack of jurisdiction, arguing that such an adjustment must be made at the partnership level.

Questions regarding this memorandum to William Davis at
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